DORSET COUNTY PENSION FUND

Quarterly Report 30 September 2016

YOUR PORTFOLIO

Fund performance objective

The fund objective is to outperform the benchmark by 0.5% per annum gross of the standard management fees.

Fund asset allocation and benchmark ranges

Fund and benchmark index	Fund allocation (%)
RLPPC Over Five Year Corporate Bond Fund Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.	100.0

Portfolio value

	Portfolio total (£m)
30 September 2016	**312.73**
30 June 2016	301.01
Change over quarter	11.72
Net cash inflow (outflow)	(10.00)

EXECUTIVE SUMMARY

Performance

- The fund gave a gross return of 7.18% over the quarter, compared with a benchmark return of 7.32%. This brings the 12 month return to 16.69% against a benchmark return of 18.12%.
- The dominant themes of the quarter were debate over the likely impact of Brexit on the UK, European, and global economies, and concern over the economic impact of November's tightly contested US presidential election. The Bank of England announced a cut in interest rates and new quantitative easing programmes, incorporating purchases of both government and corporate bonds. The oil price fell back below $50 per barrel, reflecting a lacklustre global economy, before rising sharply towards quarter end on news that Organisation of Petroleum Exporting Countries (OPEC) members had agreed to cut oil production.
- Asset allocation and a short duration stance were the primary areas of underperformance over the quarter, while credit sector selection had a positive effect upon performance.

The economy and bond markets

- The dominant themes of the quarter were debate over the likely impact of Brexit on the UK, European, and global economies, and concern over the economic impact of November's tightly contested US presidential election. Markets focused on the future path of US interest rates: consensus expectations are that no action will be taken until December at the earliest. The European Central Bank (ECB) kept its stimulus programme unchanged, but reiterated in September that quantitative easing will run until March 2017 "or beyond if necessary" to enhance growth in the eurozone. In Japan, the strength of the yen has been the main story in the first half of 2016 and the Bank of Japan (BoJ) has attempted to reverse this: towards the end of the quarter, the BoJ announced changes to its quantitative easing programme which will allow bond purchases at the shorter end of the yield curve.
- In the UK, the concern of a leadership vacuum vanished with the installation of Theresa May as the new prime minister. At the same time, further monetary easing measures announced by the Bank of England (BoE) in August and sterling weakness served to lift investor sentiment over the quarter.
- Conventional UK government bonds returned 2.34%. The market was supported by a flight to perceived safe haven assets after the Brexit vote, further quantitative easing in developed markets and a cut in UK interest rates, which resulted in UK outperformance of global bonds.
- Sterling investment grade credit returned 5.57%, rebounding strongly after the Brexit result to outperform UK government bonds over the quarter. In a reversal of the knee-jerk risk aversion at the end of June, markets rallied en masse during July; despite losing momentum somewhat during September, this was the highest quarterly return since 2009.

Investment outlook

- Mounting evidence suggests that the post-referendum shock to the UK economy was not as severe as initially feared. While we no longer forecast a short recession in the UK in the second half of the year, we expect GDP growth to remain low as the economy adjusts to the Brexit vote. We expect UK CPI inflation to rise a little above target during 2017.
- We anticipate further policy easing in the UK in the final quarter, and we expect the US Federal Reserve to raise rates after the November election. We expect European policy easing to be extended in 2017.
- Our central case is for UK government bond yields across maturities to rise over 2017, and for the yield curve to steepen marginally, although we expect some volatility around this trend. For index linked bonds, we think a long-term real interest rate of -0.17% (the level seen at the end of September) is too low, and does not reflect long-term fundamentals. We believe global inflation linked bonds offer better value
- We expect that investment grade credit bonds will outperform UK government securities by 1.5% p.a. over the next three years. We believe that the current credit spread premium over UK government bonds yields adequately compensates for default and other risks (e.g., liquidity and rating migration).

FUND PERFORMANCE

The table below shows the gross performance of your portfolio and the benchmark for the periods ending 30 September 2016:

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Q3 2016	**7.18**	**7.32**	**-0.14**
YTD	16.47	17.82	-1.35
Rolling 12 months	16.69	18.12	-1.43
Three years p.a.	11.16	10.80	0.36
Five years p.a.	12.06	10.75	1.31
Since inception 02.07.07 p.a.	9.95	10.32	-0.37

Quarterly performance

The total fund returns in the above chart include the impact of the cash holding during the quarter.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2016

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.8	98.9
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.2	1.1
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration	10.3 years	10.7 years
Gross redemption yield[3]	2.95%	2.28%
No. of stocks	289	677
Fund size	£393.4m	-

Launch date: 02.07.2007
[1] Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.
[2] Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.
[3] The gross redemption yield is calculated on a weighted average basis.
Figures in relation to the asset spilt table exclude the impact of cash where held.

Performance

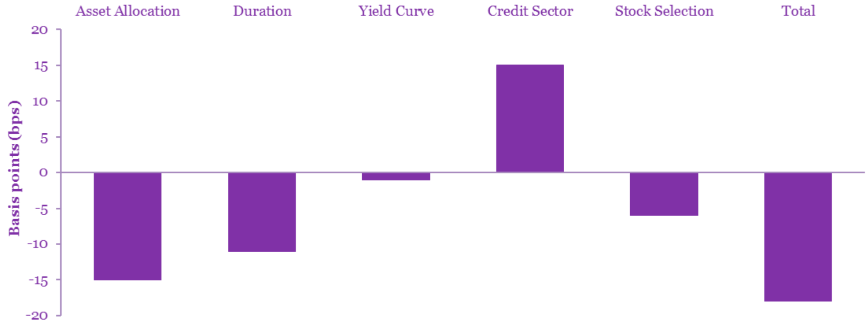
	Fund (%)	Benchmark[1] (%)	Relative (%)
Q3 2016	**7.14**	**7.32**	**-0.18**
Year-to-date	16.53	17.82	-1.29
Rolling 12 months	16.72	18.12	-1.4
3 years p.a.	11.25	10.80	0.45
Since inception p.a. (30.06.2012)[2]	10.96	9.85	1.11

[1] Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.
[2] The Fund launched 02.07.2007 but its benchmark and objective changed on 30.06.2012.Performance prior to 30.06.2012 has therefore been omitted. If you require performance prior to this change, please contact your client account manager.
Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

The Fund objective is to outperform the benchmark by 0.5% per annum gross of the standard management fees.

The Fund returns in the above table are gross of standard management fees and include the impact of cash holdings over the period.

Performance attribution for quarter 3 2016

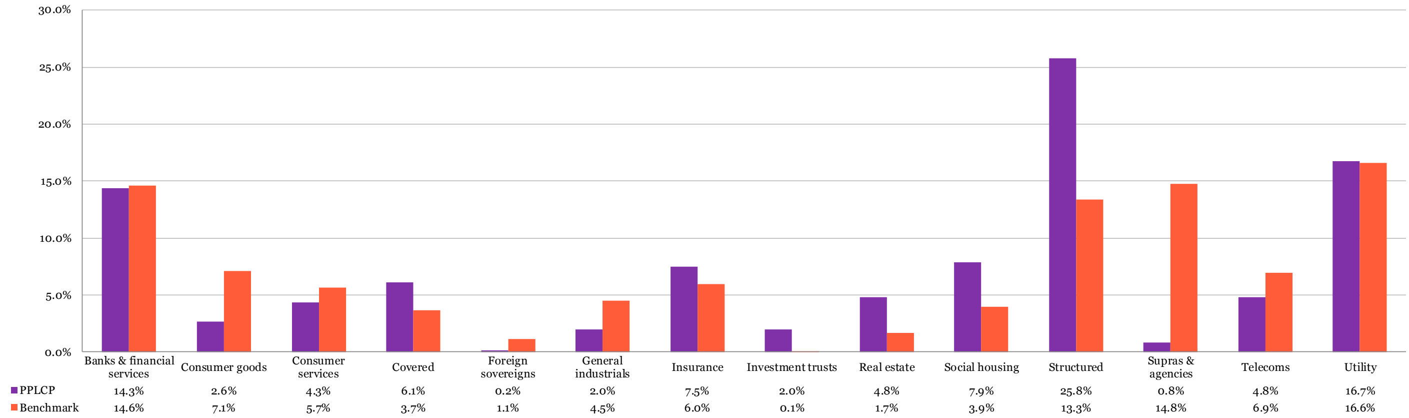


***Source:** RLAM and UBS Delta. The above performance attribution is an estimate. Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.*

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2016

Sector breakdown



Source: *RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.*

What we thought	What we did	What happened	Effect on portfolio
We expected that corporate bonds would outperform supranational debt.	We maintained the overweight position in corporate bonds versus supranational debt.	Supranational debt was one of the weakest sectors over the quarter, benefiting comparatively little from the improvement in risk appetite among investors.	The Fund's underweight positioning in supranationals was positive for relative performance, but this was partially offset by the Fund's holdings in gilts.
We continued to see value in financials (banks and insurers), and prefer a combination of covered bonds and subordinated bank debt to senior bonds.	Positioning within financials was broadly unchanged, with underweight exposure to senior unsecured debt offset by exposures to subordinated debt and covered bonds.	Despite suffering in the immediate aftermath of the post-referendum market dip, financials recovered in the second half of the quarter. Subordinated debt recovered strongly, and outperformed senior counterparts; covered bonds underperformed. Meanwhile, peripheral European and Scandinavian banks lagged, impacted by capital concerns and proposed regulatory changes.	The overweight allocation to financials and the preference for subordinated debt was positive for performance, but this was muted by the negative impact of the holding in covered bonds.
We thought that high-profile, consumer-orientated bonds and industrials were unattractively priced, relative to other sectors.	We maintained the underweight allocation to industrial and consumer sectors.	Industrial and consumer sector bonds performed well. Although commodity prices remained subdued, industrials benefited from reduced concern about the outlook for the global economy, while a number of consumer-orientated bonds were supported by inclusion in the BoE's Corporate Bond Purchase Scheme. Conversely, the automobiles sector continued to underperform as concerns around emissions persisted.	The low weighting in industrial and consumer sectors was a small negative factor in relative performance, partially offset by the lack of exposure to autos.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2016

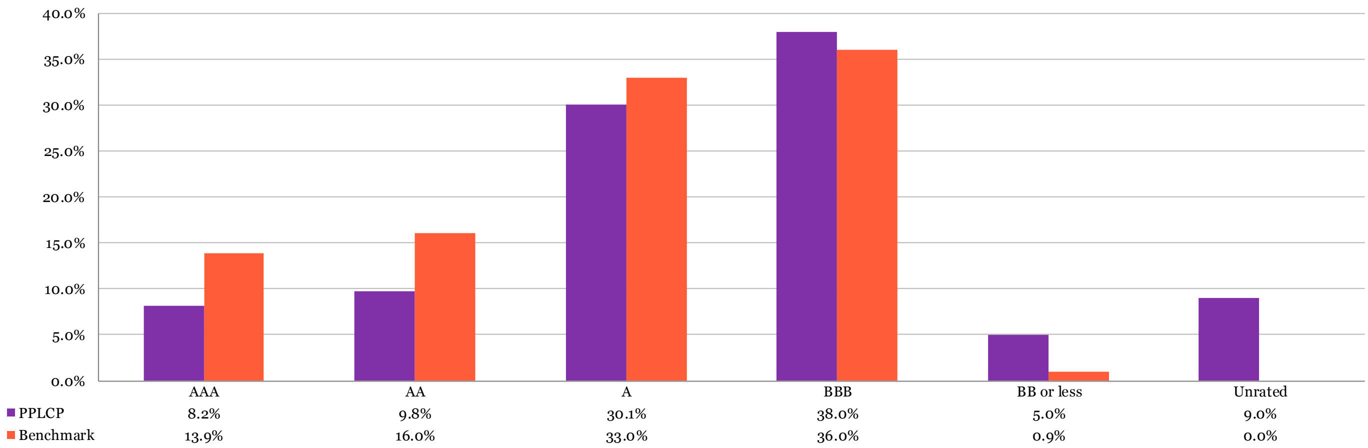
Sector breakdown continued

What we thought	What we did	What happened	Effect on portfolio
We continued to believe that secured bonds were undervalued relative to unsecured debt.	We kept the Fund's significant overweight positions in sectors that benefit from enhanced security, e.g. asset-backed securities (ABS), social housing and investment trusts.	Structured and secured sectors performed broadly in line with the market over the quarter. However, social housing was a notable exception; with housing associations excluded from the BoE's corporate bond buying programme, the sector underperformed.	The overweight positions in structured and secured debt had a broadly neutral impact upon performance, although stock selection within these areas of the market had a negative effect.

RLPPC OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2016

Rating breakdown



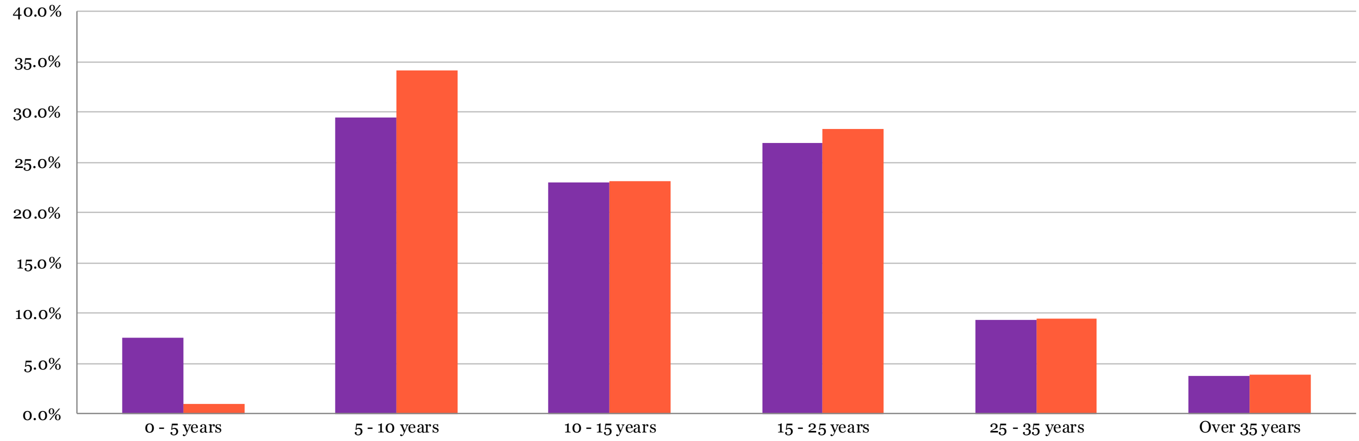
Source: *RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.*

What we thought	What we did	What happened	Effect on portfolio
We believed that lower rated credit bonds offered better value than AAA/AA rated securities.	The bias towards lower rated bonds was increased, in part a result of new issue purchases.	Lower rated bonds benefited significantly from the recovery in market sentiment during July, outperforming higher rated counterparts over the period as a whole.	The bias towards lower rated debt was beneficial for performance.
Credit ratings, while useful, are not a complete assessment of creditworthiness and value.	We maintained exposure to bonds rated below investment grade where we believed they were consistent with the overall objective of the Fund. Exposure to unrated bonds, which predominantly have investment grade risk characteristics and are in many instances secured, was broadly unchanged at 9.0%. The Fund also maintained an allocation to the Royal London Sterling Extra Yield Fund.	Market strength from the post-referendum rebound in July continued through the quarter, supporting higher risk assets.	Exposure to unrated and sub-investment grade bonds had a positive impact upon performance. The allocation to the Royal London Sterling Extra Yield Fund had a broadly positive impact upon performance.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2016

Maturity profile



	0 - 5 years	5 - 10 years	10 - 15 years	15 - 25 years	25 - 35 years	Over 35 years
PPLCP	7.5%	29.5%	23.0%	26.9%	9.3%	3.8%
Benchmark	0.9%	34.1%	23.2%	28.3%	9.5%	3.9%

Source: *RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.*

What we thought	What we did	What happened	Effect on portfolio
We expected a gradual increase in UK government bond yields.	The Fund's short duration stance was maintained over the quarter.	UK government bond yields fell dramatically following the BoE's rate cut and policy easing announcement in August, with 10-year yields reaching a new low of 0.52%, and then retracing much of this move before the end of the quarter.	The short duration position was a significant negative factor in relative performance.
We believed there were some attractive investment opportunities in short-dated credit, although these lie outside the Fund's benchmark.	The Fund maintained a position in short-dated credit bonds, partially reflecting the allocation to the Royal London Sterling Extra Yield Bond Fund.	Long-dated bonds outperformed significantly over the quarter.	The short-dated bond exposure had a negative impact upon performance.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2016

Ten largest holdings

	Weighting (%)
Lloyds Bank Plc 6% 2029	1.3
Innogy Finance 6.125% 2039	1.2
Commonweath Bank of Australia 3% 2026	1.1
Citigroup Inc 7.375% 2039	1.0
Electricite De France 6% 2114	0.9
Annington Finance 0% 2022	0.9
Abbey National Treasury 5.75% 2026	0.9
Co-operative Bank 4.75% 2021	0.9
Finance for Residential Social Housing 8.369%	0.9
Bank Of America 7% 2028	0.8
Total	**9.9**

Source: *RLAM. Figures in the table above exclude derivatives where held.*

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2016

Fund activity

- Concerns over the global economy and the outcome of the Brexit referendum weighed on companies over the first half of 2016. With significant decisions being postponed until the uncertainty abated, new issuance in sterling credit markets had remained subdued, finally picking up in quarter three as borrowing costs slumped. This followed the Bank of England (BoE)'s decision to cut the base rate in response to the Brexit result, with the UK's future relationship with the European Union remaining unclear. Across sectors, the Fund participated in a number of attractively priced new issues.
- A notable new transaction over the quarter was that of a record-sized £3bn corporate bond sale from **National Grid**. This four-part issue was split by maturity, with the Fund participating in the £700m 22-year bond issue. This was partially funded by the sale of **United Utilities**. The positions in **Affinity Water, SGSP Australia** and the structured bonds of **South East Water** were also sold over the quarter, with the third being now too short for the Fund.
- Within financials (banks and insurance), new senior unsecured bonds of **HSBC**, **Bank of America**, **Barclays**, and **Credit Suisse** were purchased, as well as subordinated debt of **TSB** and **Aviva**. The holding in **F&C Finance** was sold as it is now too short for the Fund. Other sales in the sector included **Société Général**, **DNB Norbank** and insurer **Allianz**. Holdings of **Standard Life** and **Prudential** were switched in to longer dated bonds from the issuers.
- Additions to secured and structured bonds encompassed 10-year social housing debt of **Places for People**, one of the largest national housing associations in the UK, and a new senior secured bond from **Heathrow**. The Fund also participated in a new issue of unrated secured debt of West End retail property firm **Shaftesbury Carnaby.**
- The Fund also participated in a new BBB rated issue from global luxury hotel chain **Intercontinental**, whose coupon would increase if the bonds were to be downgraded below investment grade. Other new issue purchases included bonds of **Kennedy Wilson**, the international real estate company, primarily investing across office and retail, and long-dated debt of **Vodafone**.
- Profits were taken on recent new issues from the **RAC** and from alcoholic drinks company **Brown Forman**, both of which had performed well. Elsewhere, the holding in **Walgreens Boots** was sold.
- Gilts were held and traded for duration and liquidity management over the quarter.

Key views in your portfolio

- A significant underweight in supranational bonds, as we expect corporate bonds to outperform over the medium term.
- Duration shorter than that of the benchmark, as we expect underlying gilt yields to rise.
- A bias towards asset backed securities, an area that we believe still offers the best risk/return characteristics.
- An overweight position in subordinated financial debt, where we believe yields are attractive.
- Targeted exposure to higher yielding bonds through investment in the Royal London Sterling Extra Yield Bond Fund.

ECONOMIC & BOND MARKET REVIEW

Economic review

- The dominant themes of the quarter were debate over the likely impact of Brexit on the UK, European, and global economies, and concern over the economic impact of November's tightly contested US presidential election. Markets focused on the future path of US interest rates: consensus expectations are that no action will be taken until December at the earliest. The oil price fell back below $50 per barrel, reflecting a lacklustre global economy, before rising sharply towards quarter end on news that Organisation of Petroleum Exporting Countries (OPEC) members had agreed to cut oil production in a co-ordinated move to shore up pricing.
- The US Federal Reserve (Fed), having signalled a less aggressive path to policy tightening at the end of the previous quarter due to the unexpected result of the Brexit referendum, kept rates on hold for the sixth policy meeting in a row. Following its September meeting the Fed released a follow-up statement highlighting that the labour market had continued to strengthen and that growth of economic activity had picked up from the modest pace seen in the first half of this year. The statement reflected the Fed's view that its inflation target would be hit as the labour market continued to strengthen.
- Towards the end of the quarter, fears grew over the financial strength of Deutsche Bank, and this was negative for sentiment towards financials, especially European banks. The European Central Bank (ECB) kept its stimulus programme unchanged, but reiterated in September that quantitative easing will run until March 2017 "or beyond if necessary" to enhance growth in the eurozone. Recent economic data remained positive – September's Purchasing Managers Indices survey remained well above the 50 mark (indicating expansion), while bank lending to companies in the eurozone rose 1.9% in July, the fastest pace since October 2011. Meanwhile, headline inflation in the single currency area remained above zero, but with little obvious upward pressure in the short term.
- In Japan, the strength of the yen has been the main story in the first half of 2016 and the Bank of Japan (BoJ) has attempted to reverse this: towards the end of the quarter, the BoJ announced changes to its quantitative easing programme which will allow it to have short-term flexibility to focus bond purchases at the shorter end of the yield curve. This monetary easing has arguably reduced the risk of further yen appreciation. Meanwhile, economic data released during the quarter remained mixed – retail sales and consumer spending were weak, while the Japanese economy watchers survey hinted at a mild recovery in the economic outlook.
- In the UK, equity markets recovered sharply from the initial fall-out, with the FTSE 250 index reaching an all-time high around the quarter end. In effect, uncertainty following Brexit has been dismissed and the concern of a leadership vacuum vanished with the installation of Theresa May as the new prime minister. At the same time, further monetary easing measures announced by the Bank of England (BoE) in August and sterling weakness have served to lift investor sentiment over the quarter.

Bond Market Review

- **Conventional UK government bonds returned 2.34%.** The market was supported by a flight to perceived safe haven assets after the Brexit vote, further quantitative easing in developed markets and a cut in UK interest rates, which resulted in UK outperformance of global bonds. On a duration-adjusted basis, medium-dated gilts outperformed short and long-dated gilts. The BoE cut the bank rate from 0.5%, to 0.25% and restarted its quantitative easing programme, including the purchase of corporate bonds. The UK government bond yield curve steepened as longer-dated bond yields fell less than medium-dated issues. However, the fall in longer dated yields resulted in the FT-Actuaries Greater than 15 Year Index rising 4.3%, and it is up by 26.0% (in total return terms) since the start of the year. The UK Consumer Price Index continued to remain well below the BoE's 2% inflation target. However, the depreciation in sterling should result in a sharp pick-up in inflation. The Debt Management Office announced the issuance schedule for the current quarter, which comprised three short, four medium and four long-dated issues.
- **Index linked UK government bonds returned 10.1%.** Brexit concerns, quantitative easing and a weaker pound fuelled demand for both shorter dated maturities (from overseas investors) and longer dated maturities (from pension funds), with yields falling by 30-50 basis points (bps) across the curve. Good demand for 10-year index linked gilts resulted in their yields falling by around 50bps. Demand for longer dated bonds was more sporadic, with real yields in the 30-year sector falling by around 30bps. The July syndication of the 2065 maturity weighed on the market for some time. The weakness in sterling, allied with surprisingly positive inflation data, led to breakeven rates rising by over 30bps for 10-year maturities and by 20bps at the longer end.
- Index linked UK government bonds outperformed global counterparts, with real yield differentials rising to record highs; in the UK, strong pension fund demand caused long-dated real yields to fall to record lows. By contrast, speculation of further US rate hikes, coupled with disappointment that the ECB did not extend its monetary easing, meant real yields in these regions were broadly unchanged. Sterling non-government index linked bonds underperformed index linked gilts by around 0.10%.
- After the particularly strong showing for **overseas sovereign bonds** in the second quarter, returns in the third quarter, while positive, were less impressive. The J.P. Morgan Global Government Bond Index (TR) rose by 3.1%, compared with 15.6% over the last two quarters combined. Government bond markets rallied, supported by quantitative easing and measures perceived as a necessary evil in the absence of signs of sustained economic growth, and limited upward pressure on global interest rates and inflation. Low deposit rates and an uncertain dividend growth outlook for equity investors nudged government bond yields lower. European government bonds outperformed both US and Japanese counterparts. The J.P. Morgan European, US and Japanese Government Bond indices rose by 4.3%, 2.6% and 2.0% respectively (in sterling total return terms).

- **Sterling investment grade credit** returned 5.57%, rebounding strongly after the Brexit result to outperform UK government bonds over the quarter. In a reversal of the knee-jerk risk aversion at the end of June, markets rallied en masse during July; despite losing momentum somewhat during September, this was the highest quarterly return since 2009. Average sterling investment grade credit spreads narrowed by 40bps to 118bps. All sectors narrowed over the quarter, led by the basic industry, utilities and subordinated financials. While the first two were supported by the BoE's corporate bond purchasing programme, the strength of subordinated financials reflects an improvement in risk sentiment over the quarter from the trough of aversion in the aftermath of the Brexit result.
- Secured and structured bonds in real estate and asset-backed areas performed broadly in line with the market, as did the financials sector. Supranational debt benefited least from the spread narrowing trend, having been less affected by the buoyant market rebound of July. Similarly, more defensive sectors such as consumer goods and telecoms, while generating positive returns, were less remarkable. Sterling bond issuance increased markedly, boosted by a surge in financials issuance, having been very slow in the first half of the year. Lower-rated bonds generally outperformed their higher-rated counterparts. By maturity, longer-dated issues outperformed significantly.
- **Global high yield bonds** (BofA Merrill Lynch BB-B Global Non-Financial High Yield Constrained, 100% hedged to sterling) returned 4.78%. Despite being negatively affected at the end of June by risk aversion in the immediate aftermath of the Brexit referendum, high yield, along with other risk assets, recovered during the third quarter. Global new issuance was over $106bn, up 96% versus the same period last year. The index yield ended the quarter 0.91% lower at 5.01%, with the average high yield credit spread narrowing by 103bps to 415bps above government bond yields. The UK was the strongest performing region, returning 6.20%, followed by the US and emerging markets, which returned 5.49% and 5.04%, respectively. Europe lagged, with a return of 3.45%. B rated bonds outperformed BB rated bonds, with returns of 5.89% and 3.98% respectively. Outside the benchmark index, the High Yield CCC & Lower index returned 8.65%. Returns for medium-maturity issues outperformed short and long-dated maturities.

INVESTMENT OUTLOOK

Key points

- Mounting evidence suggests that the post-referendum shock to the UK economy was not as severe as initially feared.
- While we no longer forecast a short recession in the UK in the second half of the year, we expect GDP growth to remain low as the economy adjusts to the Brexit vote. We expect UK CPI inflation to rise a little above target during 2017.
- We anticipate further policy easing in the UK in the final quarter, and we expect the US Federal Reserve to raise rates after the November election. We expect European policy easing to be extended in 2017.

Global economic growth prospects

- In the US, labour markets are improving and inflation remains low. Consumer confidence measures are still strong, with few signs of imminent recession, although corporate profits have been hit by a sharp squeeze on the energy sector over the past two years. Consumer spending growth continues to be robust, supported by rising employment and real income growth. We expect that the Fed will raise rates in December.
- In the UK, while we expect growth to slow markedly in the second half of the year from the +0.6% in the third quarter, we no longer expect GDP growth to turn negative. The Bank of England exceeded our expectations for policy easing in August. We expect another rate cut in November to 0.1%, with the MPC minutes indicating that a majority of members supported lowering the bank rate further – 'close to but a little above zero'.
- The success of the UK government in creating new trading relationships with the rest of the world will be of great importance in the medium to long term. While the negotiations unfold, uncertainty will continue to characterise the economic backdrop and to weigh on the value of sterling. We expect UK CPI inflation to rise a little above target during 2017.
- In the eurozone, there appears so far to be limited impact from the Brexit vote. Growth, however, remains tepid, and inflation far below target. Political risks will build from the Autumn, beginning with the Italian referendum on constitutional change, and 2017 will see elections in the Netherlands, France and Germany, against the backdrop of a growing anti-establishment vote. While the ECB took no action at its September meeting, we expect that the current monetary easing policies will be extended beyond their March 2017 deadline.
- The market is not particularly animated about China at present, although we know there tends to be at least one major China agitation per year. Recent data have been firm, and already voices in the market are calling for another downturn. Macroprudential measures are being applied to cool the housing market in some regions. There is also a view that recent policy stimulus was of 'the wrong sort' and will exacerbate imbalances. Most data remain in line with, or a little ahead of our base case. A pick-up in nominal GDP growth as industrial deflation eases, should ease pressure on debt levels.

Outlook

- We expect global government bond yields to rise from current levels, as inflation outlook and global growth picks up. We expect the Fed to raise rates in December and then a further two times in 2017. Our base case assumes a gradual rise yields over the next 12 months.
- Our central case is for **UK government bond yields** across maturities to rise over 2017, and for the yield curve to steepen marginally, although we expect some volatility around this trend.
- In **overseas bond markets,** we believe the global economy will to continue to grow over the near term. Events in the eurozone, where the situation remains unpredictable, will continue to impact market sentiment. We find the current yields on eurozone government bonds unattractive.
- We believe that real yields for both 10- and 30-year gilts will rise over the next 12 months. Sustained inflation looks unlikely, unless economic growth picks up much faster than expected. Nor does a prolonged period of deflation seem probable. Breakeven (implied) inflation rates at current levels offer longer-term value across the majority of global markets, the notable exception being the UK. We consider developed market government bonds to be expensive. Yields should rise over the next 18 months.
- For **index-linked bonds**, we think a long-term real interest rate of -0.17% (the level seen at the end of September) is too low, and does not reflect long-term fundamentals. Pension fund demand for longer dated, real yield securities remains strong, and has picked up after the Brexit vote as deficits have reached new highs. We believe global inflation linked bonds offer better value, with the real yields of European and US bonds approximately 1.2% and 2.4% higher, respectively, than their UK counterparts. We think that 5- and 10-year breakeven (implied) inflation rates of around 2.8% now look fair value on a longer-term view. However, long-dated breakeven rates of 3.3% appear to be above fair value.
- We expect that **investment-grade credit bonds** will outperform UK government securities by 1.5% p.a. over the next three years. We believe that the current credit spread premium, over UK government bonds yields, is adequate compensation for default and other risks (e.g. liquidity and rating migration). Portfolio diversification continues to be important during bouts of volatility, and a focus on bonds supported by stable income streams and structural enhancements should provide protection in times of market turbulence.
- We continue to believe that **global high yield bonds** are attractive on a spread basis and overcompensate for default risk, while their level of income generation is also appealing on a relative basis. The current growth and rate environment provides a moderate albeit rising default climate, with ongoing refinancing opportunities.

CORPORATE GOVERNANCE & COMPLIANCE

MiFID (Markets in Financial Instruments Directive)

- Pursuant to the FCA rules and based on information that we hold about you, we have classified you a 'Professional Client'.

Whistleblowing requirements of the Pensions Act

- We confirm that we have not made any reports to the Pensions Regulator during the quarter, as we do not believe there has been a breach of law relevant to the administration of the scheme.

The UK Stewardship Code and Royal London Asset Management

- Our voting records and the details of how RLAM approaches the stewardship of the securities we hold on behalf of our clients are disclosed on our website: www.rlam.co.uk.
- RLAM has a dedicated Governance Team which implements RLAM's Voting Policy across all UK holdings. Our public voting records are fully transparent, searchable and updated on a monthly basis. We also disclose information publicly about our engagement with companies on a quarterly basis.
- RLAM supports the principles of the UK Stewardship Code. Our underlying belief is that management are appointed by the shareholders to manage the business in the best interests of shareholders over time. While engagement is largely from an equity investors perspective, given that in most instances there is a limited amount of leverage that a bond holder can exercise over the issuing company, our own experience is that we are becoming more involved in corporate bond restructuring and in many cases these involve a bond holder vote. We ensure that we approach such decisions in the same way we would on an equity issue in aiming to support management where appropriate but always seeking to enhance value on behalf of our underlying clients.
- All enquiries with respect to our voting and engagement activities should be directed in the first instance to the RLAM Chief Investment Officer.

Responsible Investing

- RLAM is committed to being a responsible investor. This means being a good steward of our client's assets and promoting responsible investment with other stakeholders.
- In 2008, Royal London Asset Management became a signatory to the United Nations Principles for Responsible Investment (PRI), and was an early signatory to the UK Stewardship Code. This set the company on a long-term commitment to making responsible ownership 'business as usual'.
- The aim is to generate sustainable, risk adjusted returns that reflect a wider understanding of what will drive economic performance in the future.
- We seek to understand environmental, social and governance risks and opportunities within the investment process.
- We engage with companies and industry regulators to understand the issues that are most material to their business, and to promote best practice.

Engagement

- Engagement refers to our dialogue with companies, regulators, non-governmental organisations and other agents in the investment chain to support better standards of behaviour, risk management and reform for a more sustainable economy.
- Engagement will normally meet more than one of the following criteria:
- Materiality to investment performance
- Importance to our clients
- Reputational impact
- We track our engagements and report on the outcomes in quarterly public reports and to the PRI.
- We initiate or join collective engagements with other investors where we believe it will be more effective than engaging alone, or to draw attention to a worthy topic.

Our relationships with our broker counterparties

- We currently deal through approximately 50 brokers globally; a mixture of global firms and regional specialists which enables us to access different information flows and therefore, enhances the overall investment process.
- We undertake a comprehensive broker rating/review process where all brokers used are scored for the quality and utility of their research, dealing abilities, administrative efficiency, accuracy and sales advice. To get a full picture, we involve fund managers, dealers and any comment from the back-office. We do not have soft commission arrangements with any counterparties.

RLAM TEAM

Your fund managers

Jonathan Platt
Head of Fixed Interest

Paola Binns
Senior Credit Fund Manager

Your dedicated contact

James Stoddart
Head of Client Account Management

T: 020 7506 6619
F: 020 7506 6784
E: james.stoddart@rlam.co.uk

In James' absence, please feel free to contact any of the Client Relationship team members listed below or email: ClientRelationships@rlam.co.uk.

Lucy Bramwell	T: 020 7506 6537	E: lucy.bramwell@rlam.co.uk
Fraser Chisholm	T: 020 7506 6591	E: fraser.chisholm@rlam.co.uk
Victoria McArdle	T: 020 7506 6563	E: victoria.mcardle@rlam.co.uk
Rob Nicholson	T: 020 7506 6736	E: robert.nicholson@rlam.co.uk
Daniel Norsa Scott	T: 020 7506 6602	E: daniel.norsascott@rlam.co.uk

Corporate team changes

In July, Nick Woodward joined RLAM as Head of Liability Driven Investments (LDI). Nick joined us from BMO Asset Management and reports directly to Jonathan Platt, Head of Fixed Income, and is working with consultants to produce high quality, bespoke solutions for current and prospective RLAM clients. These solutions are a natural evolution of our offering to pension funds, and will complement our existing active credit and Buy & Maintain strategies.

In August, we expanded our global high yield team with the appointments of a new fund manager, a senior credit analyst and two assistant credit analysts, ahead of the launch of a multi asset credit fund in 2017. Khuram Sharih joined as a fund manager, focusing on leveraged loans and alternative credit, having previously worked at Newton Investment Management, where he worked with their fixed income and global multi asset teams. Sebastien Poulin joined as a senior credit analyst with a remit split between high yield and leveraged loans. Prior to RLAM, Sebastien was at Principal Global Investors where he covered both high yield and leveraged loans. Gary Ewen and Tom Elliott have also joined to bolster our multi asset credit capabilities. Gary was an investment analyst at Mercer and Tom was a high yield credit analyst at Debtwire.

In September, Henry Lowson joined us as a senior fund manager, taking over the RL UK Smaller Companies Fund after the departure of Victoria Stewart. Henry joined us from AXA Framlington. He is working closely with Derek Mitchell, manager of RLAM's UK Mid Cap and UK Opportunity Funds, as well as the wider equities team to expand RLAM's Alpha strategies within the UK equity market.

GLOSSARY

ABS – Asset backed securities – Debt secured against assets of the issuer.

Amortisation – Incremental repayment of a bond over its lifetime.

Attribution – The measurement of a fund's return versus the underlying benchmark return that breaks up the active performance into component parts:

> **Stock selection** – Performance attributed to stock selection.
>
> **Yield curve** – Performance attributed to positioning on the yield curve.
>
> **Duration** – Performance attributed to relative duration of the portfolio versus that of the benchmark.
>
> **Asset allocation** – Performance attributed to asset allocation between fixed interest gilts and credit bonds.

Basel – The Basel Committee on Banking Supervision provides a forum for regular global co-operation on banking supervisory matters.

Benchmark – An index or other market measurement that is used by an investment manager as a standard against which to assess the risk and performance of a portfolio.

Book cost – A measure of the historical cost of a bond or a portfolio of bonds represented as a clean value. It is calculated as the product of the number of bonds held and the average price paid. It remains unchanged regardless of movements in market price. If the price paid is the same as the face value of the bond, book cost will be the same as the nominal value.

Breakevens – The level of inflation required to make the return on index linked bonds equal to return on conventional bonds of similar maturity.

Capital cover – The degree to which debt is covered by the assets of the issuer.

Certificate of deposit (CD) – A certificate of deposit is a negotiable receipt issued by a deposit taking institution in respect of a specified sum of money deposited with that institution at a fixed rate of interest, with an undertaking to repay to the bearer of the certificate at a specified date the sum deposited with interest outstanding. The term of a CD generally ranges from one month to five years – with annual interest payments for those that are issued for longer than a year.

CDO – Collateralized debt obligations – A relatively small subset of the wider ABS market, CDOs are securitisations of a pool of debt receivables (that are not secured on tangible property). Typically, these securities are divided into different tranches: senior tranches, mezzanine tranches and equity tranches. Losses are applied based on the seniority of the tranche, with the most junior tranche absorbing losses first. The bonds are tranched to provide investors with different levels of seniority and credit rating. Variations include collateralised loan obligations (CLOs) and collateralised synthetic obligations (CSOs), where the underlying pools of assets are corporate loans and credit default swaps (that are not secured on tangible property).

Consumer price index – An index number calculated as the weighted average price of consumer goods and services.

Coupon – Interest paid by the bond issuer expressed as a percentage of the face value of a bond; typically paid annually or semi-annually.

Covenant – Legal rules found in bond documentation that place restrictions on the issuer.

Covered bond – Senior bonds issued by banks and collateralised by a high quality pool of residential mortgage assets.

CDS – Credit default swaps – Insurance purchased to protect against the default of a bond. In the event of default, the CDS buyer receives the face value of the bond in return for delivering the bond to the provider of protection.

Credit rating – A rating agency (Moody's, S&P, Fitch) measure of the credit worthiness of a bond issuer – investment grade credit ratings range from AAA to BBB with BB and below referred to as sub-investment grade (sometimes known as 'junk bonds' or 'high yield'). In general, for investment grade credits the rating agency rates only on the probability of default and does not take into account the potential recovery prospects of the bond.

Credit spread – Extra yield offered to compensate the holder of a credit bond versus an underlying risk free bond of similar maturity. Specifically, the holder requires compensation for the expected loss on default, reflecting a combination of probability of default and recovery rate on default. Compensation may also be required for extra market risk and liquidity risk.

Cyclicals – Bonds/stocks that are sensitive to the economic cycle.

Default – Failure of a bond issuer to pay the coupon, or principal when required, on a debt instrument.

DTS – Duration times spread – An expression of the portfolio's sensitivity to changes in yield spreads (the difference between the yields of credit bonds and government bonds) based on proportional spread movements. DTS is an appropriate measure for credit portfolios in particular, and for managers with particular skill in sector and stock selection and a focus on these.

Duration – A measure of the sensitivity of the portfolio to small and uniform changes in bond yields across the maturity spectrum. Duration, also referred to as interest rate risk, is expressed in years as a result of the measure's calculation from the weighted average maturity of all of the portfolio's discounted future cash flows.

ECN – Enhanced capital notes. ECN is a subordinated debt instrument issued by Lloyds Banking Group as part of the 2009 capital restructuring. The bonds were issued in exchange for Lloyd's existing upper tier 2 and tier 1 bonds and are lower tier 2 in the capital structure. Although the regulator also classifies these instruments as LT2, for the purposes of stress testing they are included in the equity capital base of the bank. Coupon payments of ECNs are not deferrable and the bonds are dated. However, should the core tier 1 capital ratio fall below 5%, the ECNs will mandatorily convert into equity.

European Financial Stability Facility (EFSF) – Agreed in May 2010 by EU member states, the temporary program can issue bonds or other debt instruments to raise funds needed to provide financial assistance to eurozone states in economic difficulty. The EFSF is financed by members of the eurozone.

European Stability Mechanism (ESM) – A permanent rescue fund program designed to replace the temporary EFSF which commenced operations in October 2012.

FRN – Floating Rate Notes – a bond with a variable coupon. Typically, coupons of sterling FRNs are referenced against 3 month LIBOR and are reset quarterly.

Funding for Lending Scheme (FLS) – Launched in July 2012, the scheme is designed to lower bank funding rates by allowing banks and building societies to borrow directly from the Bank of England for up to 4 years. Those that increase lending to UK households and businesses will be able to borrow more in the FLS, and do so at lower cost than those that scale back lending.

Futures – A contract between two parties where one agrees to buy and the other to sell an underlying instrument at a future date at a price agreed at the start of the contract.

FX – Foreign exchange.

Gearing – The level of debt to equity.

Interest cover – The degree to which interest expense is covered by the profit of the issuer.

Interbank rate – Lending rate between banks in the wholesale money market; LIBOR stands for London InterBank Offered Rate.

Internal rating – RLAM's assessment of the creditworthiness of a bond; crucially this takes account not only of the probability of default of a company but also the likely recovery rate on default.

Investment restrictions – Restrictions imposed on the portfolio managers by clients as outlined in the investment management agreement (IMA).

Liability management exercise (LME) – Under certain circumstances, companies can offer to buy back or swap their bonds at a discount to par value in order to boost capital reserves. This process has been used most extensively in the financial services sector and, typically, these exercises have been undertaken at premiums to prevailing market prices.

Loan to value (LTV) – Expressed as a %, the value of the loan to the value of the assets backing the loan.

LDI – Liability driven investment – Investing in order to match liability cash flows with asset cash flows. This is often achieved using derivatives products to overlay a bond portfolio in order to control duration.

LTRO – Long Term Repo Operation – European Central Bank debt facility to provide 3 year term funding to European financial institutions.

Market value – Market value reflects the value of a security after issuance as influenced by movements in underlying gilt prices and the market's assessment of credit risk. The value of bonds held in the portfolio reflects this market value. Although borrowers typically pay coupons on an annual or semi-annual basis, different treatment of the accrual of coupon payments results in two market value definitions.

Market value clean – Accrued interest is calculated separately and not reflected in the clean market value.

Market value dirty – The market value includes accrued interest.

Maturity – Final payment date of a bond, requiring the borrower to repay the bond.

MBS – Mortgage backed securities – An asset backed security (ABS) where cash flows are backed by the principal and interest payments of mortgage loans. RMBS relates to residential MBS. CMBS refers to commercial MBS.

Monoline insurance company – The original business model of the monoline insurers was to provide credit-wrapping (credit insurance) of lower rated bonds by guaranteeing the payment of coupon and principal of the underlying bonds in return for premium payments. This sector had been characterised by decades of unbroken profitability and the consistent maintenance of AAA credit ratings, however, over the past ten years, the focus of the sector shifted from the US municipal market to the credit-wrapping of structured products, such as sub-prime RMBS and CDOs. As losses in these instruments have increased in recent years, concerns have arisen regarding the adequacy of the insurers' claims paying reserves. This has resulted in material rating downgrades within the sector. Following these downgrades, a large majority of credit wrapped bonds are now rated according to the underlying credit quality of the issue rather than the monoline's rating. The main monoline insurance companies are AMBAC, MBIA, FSA and FGIC.

Nominal value – Also known as the face value. It refers to the price of a security when issued. For fixed income assets, nominal value is the product of the number of bonds issued and face value per bond (usually denoted by 1,000). Within the portfolio valuation, nominal value represents a client's holding in a bond expressed at face value.

Operation Twist – The name given to the Federal Reserve's monetary policy designed to lower long term interest rates by selling short-term Treasury bonds in its portfolio and buying longer-term Treasury bonds.

Outright Monetary Transactions (OMT) – An unlimited bond-buying scheme aimed at cutting the borrowing cost of debt-burdened eurozone members by buying their short-dated bonds, but only after countries have requested a bailout from the European Central Bank. The scheme was announced in September 2012.

PFI – Private finance initiative – Projects that involve the provision of assets for the public sector by private companies. For instance, the Octagon PFI involves the design, financing, construction and operation of Norfolk & Norwich Hospital by a private company for the Norfolk & Norwich NHS Trust.

Quantitative easing – In March 2009, the Bank of England (BoE) announced its intention to purchase UK government bonds (primarily medium dated UK government bonds) by creating new money (effectively printing money, but electronically). The process was subsequently paused by the Band of England during the first quarter of 2010 and later restarted in the fourth quarter of 2011. This process of purchasing assets through 'printing' money is called quantitative easing (QE).

Redemption yield – The annual interest rate on a bond including any capital gain or loss if it were held to redemption and assuming that all coupon and principal payments are made. If the coupon rate exceeds the redemption yield, then the bond will experience capital loss as it approaches maturity and vice versa.

Sale & leaseback – A process by which a company sells an asset then leases it back.

Securities Market Program (SMP) – A monetary policy tool aimed at providing market liquidity by allowing the European Central Bank to purchase distressed government bonds of peripheral European countries.

Seniority/subordination – Represents a bond holder's relative claim on the assets of an issuer before or after default.

Structured bonds – Bonds issued by a legally separate structure and secured on assets. The structure is often tranched, with different credit ratings for different levels of seniority. The process of issuing structured bonds is often referred to as securitisation.

Sub-investment grade – A credit rating that is below BBB-, also referred to as high yield or junk.

Sub-prime – Riskier mortgage lending to non-prime borrowers.

Supranationals – International non-government agencies/institutions such as the European Investment Bank and the World Bank.

Swaps – A derivative product representing an agreement to exchange one series of cash flows for another.

Interest rate swaps – Exchange fixed cash flows for floating cash flows or vice versa.

Inflation swaps – Exchange inflation index linked cash flows for conventional cash flows or vice versa.

Swaption – This derivative gives the holder the option (a right but not an obligation) to enter into an underlying swap.

Tracking error – Defined as the standard deviation of the fund's excess return over the benchmark index return, and generally quoted as an annualised figure based on monthly observations. This measure quantifies how closely the portfolio's return pattern follows that of a benchmark index. It is an important concept in risk measurement, and is used as both an ex post (historic) and ex ante (expected) measure. RLAM employs systems that allow us to estimate the ex ante tracking error of a portfolio.

Underwriting – The process by which an underwriter guarantees the new issue of securities (equity or bond).

Unrated bonds – Bonds that are not rated by any of the rating agencies; traditionally, unrated bonds benefit from security over the assets of the issuer. Unrated bonds are assigned an internal rating by RLAM.

Yield – Interest rate earned on a bond, expressed as an annual percentage.

Yield curve – The relation between the interest rate and the time to maturity of a bond.

Issued by Royal London Asset Management October 2016.

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Portfolio Valuation

As at 30 September 2016

Dorset County Pension Fund

	Holding	Identifier	Asset Description	Market Price (Bid £)	Book Cost Capital (£)	Market Cap. Value (£)	Accrued Inc. Value (£)	Market Value (£)	Days Accrued	Market Value %
Funds Held										
	134,150,594	GB00B1ZB3X88	RLPPC Over 5 Year Corp Bond Pen Fd	2.33122	168,500,432.15	312,734,546.60	0.00	312,734,546.60	0	100.0
				Funds Held total	**168,500,432.15**	**312,734,546.60**	**0.00**	**312,734,546.60**		**100.0**
				Grand total	**168,500,432.15**	**312,734,546.60**	**0.00**	**312,734,546.60**		**100.0**

Trading Statement

For period 01 July 2016 to 30 September 2016

Dorset County Pension Fund

	Trade Date	Transaction Type	Nominal	Security	Price (£)	Book Cost (£)
Acquisitions						
Funds Held						
	06 Jul 2016	Acquisition Rebate	97,196.15	RLPPC Over 5 Year Corp Bond Pen Fd	2.25	218,513.47
					Funds Held total	**218,513.47**
					Acquisitions total	**218,513.47**

Trading Statement

For period 01 July 2016 to 30 September 2016

Dorset County Pension Fund

	Trade Date	Transaction Type	Nominal	Security	Price (£)	Book Cost (£)	Proceeds (£)
Disposals							
Funds Held							
	16 Aug 2016	Disposal	4,238,257.91	RLPPC Over 5 Year Corp Bond Pen Fd	2.36	5,323,482.15	10,000,000.00
					Funds Held total	**5,323,482.15**	**10,000,000.00**
					Disposals total	**5,323,482.15**	**10,000,000.00**